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No. 140

In the Supreme Court of the United States

OCTOBER TERM, 1968

GOOD-ALL ELECTRIC MANUFACTURING COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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From its inception in 1949 petitioner manufactured capacitors, almost entirely for use by the Navy in proximity fuses (Pet. 36). During its first five taxable years ending May 31, 1954, its gross sales and earnings increased substantially.[1] Cash on hand and

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[1] As reported in petitioner's tax returns, taxable income increased from $323,366.13 in 1950 to $3,405,106.25 in 1954. After making some upward adjustments asserted by the

earned surplus at the end of each fiscal year were as follows (Pet. 37):

Fiscal Year Ending May 31	Cash	Earned Surplus and Undivided Profits
1950	$ 515,940.38	$ 323,366.13
1951	685,997.36	955,421.46
1952	2,269,514.88	1,138,748.37
1953	1,619,636.41	1,581,729.06
1954	3,198,585.98	2,528,642.29

Petitioner declared no dividends during the five-year period. (*Ibid.*)[2] Over the same period, however, petitioner's two shareholders withdrew from the corporation in the form of non-interest bearing loans approximately $1,660,000, almost all of which was used to finance the shareholders' personal investments in oil properties. (Pet. 67.)

The Commissioner determined deficiencies in petitioner's income tax for the fiscal years ended May 31, 1950, through 1954. The deficiencies for the last four of these years were based in substantial part upon imposition of the accumulated earnings tax.

In a suit for redetermination the Tax Court sustained the imposition of that tax.[3] (Pet. 73-80.) The

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Commissioner for all five years, and deducting amounts later repaid to the government upon order of the Renegotiation Board for 1951 through 1954, see p. 4 n.5 *infra*, the Tax Court found that petitioner's income increased from $382,022.99 in 1950 to $2,070,892.48 in 1954 (see Pet. 7).

[2] The parties stipulated that certain amounts paid to petitioner's shareholders were constructive dividends. The total amount so characterized was $43,456.74. (Pet. 7.)

[3] Other issues affecting petitioner's tax liabilities were resolved by stipulation in the Tax Court. The case was con-

court of appeals affirmed, except with respect to two items in the computation of the amount of the tax that are not at issue in this Court (Pet. 36-57).

The decision below is correct. There is no conflict of decisions or other basis for further review.

1. Petitioner makes no direct attack on the ultimate finding of the Tax Court, for which the court of appeals found abundant support in the record, that petitioner accumulated its earnings beyond the reasonable needs of its business for the purpose of avoiding income tax at the shareholder level (Pet. 36-53, 78-80).[4] Instead, petitioner makes the lesser argument that the lower courts erred in not specifying petitioner's earnings and reasonable business needs in exact dollar amounts.

As to the earnings, the Tax Court reiterated what petitioner's own records showed as earned surplus at

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solidated with those involving the tax liabilities of the shareholders, as to which certiorari has not been sought.

[4] Section 102(a) of the Internal Revenue Code of 1939 imposes a special tax on the "undistributed section 102 net income" (as defined in Section 102(d)(2) of the statute) of a corporation at the rate of 27½ percent of such income not in excess of $100,000 and 38½ percent of such income in excess of $100,000. Every corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders * * * through the medium of permitting earnings or profits to accumulate instead of being divided or distributed" is subject to the tax. Section 102(c) of the 1939 Code provides that if "earnings or profits * * * are permitted to accumulate beyond the reasonable needs of the business", that fact is determinative of the proscribed purpose unless the taxpayer "by the clear preponderance of the evidence shall prove to the contrary." The comparable provisions of the 1954 Code are Sections 513-537.

the end of each year (see Pet. 75). In computing the amount of the accumulated earnings tax the Tax Court adjusted these data to reflect later determined renegotiation liabilities[5] and other adjustments to petitioner's income for those years that resulted from the resolution of the other issues in the Tax Court. But, it is not so, as petitioner argues (Pet. 13-14), that the Tax Court, in determining whether earnings had been accumulated for the improper tax avoidance purpose, should have assumed that the earnings had been less than the books showed when the decision was made to accumulate. Whether the accumulated earnings tax applies ultimately involves an inquiry into the state of mind of those who controlled the corporation at the time of the accumulations. See *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282, 292-294. That inquiry necessarily rests on what the corporate managers thought the income was when they decided to accumulate rather than distribute the surplus. Since the renegotiation liabilities for each of the years involved were not raised or fixed until after

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[5] We are aware of no basis for petitioner's claim (Pet. 20) that in the computation of the amount of income subject to the accumulated earnings tax, it was entitled to a deduction for the amount of taxes shown on its original returns rather than the lesser amount actually paid by reason of the adjustments for federal taxes previously paid which where allowed as a setoff in computing the net repayments to the government in the renegotiation proceedings. (Internal Revenue Code of 1939, § 3806(b); See Doc. No. 16 per Tax Court Clerk's numbering of the original record, and Doc. No. 105, Schedules 4 and 5.) Under its theory, petitioner would receive a double deduction for those taxes.

the respective accumulations occurred[6] and petitioner's books never reflected a reserve for possible renegotiation liabilities, the Tax Court was justified in concluding that those liabilities were not part of the motivation of the accumulation.[7]

Nor is there a requirement that the Tax Court find, in a set dollar amount, the reasonable needs of the business during the years in issue. Rather, Section 534(a) of the 1954 Code, which applied to the trial of this case (see Section 534(e)(2)), places on the taxpayer the burden of coming forward, either in a statement served on the Commission (Section 534(c)) or at trial (see Section 534(a)), with the facts showing that the accumulations were justified by the needs of the business. For this purpose, petitioner offered an analysis of claimed needs for working capital in the 1950-1954 period, a study developed just prior to the trial (Pet. 47) and which is summarized in a table printed at p. 7 of the petition. Nowhere, however, does petitioner deal with the facts of record that the court below thought justified the Tax Court's refusal to credit these assertions; it indeed pointed to more than a

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[6] In March 1952 the Renegotiation Board first notified petitioner that its fiscal year 1950 was being considered by the Board (Pet. 39). Tentative notices of renegotiation liability for 1951-1954 were first received after May 31, 1954, the end of the period here in issue. (Pet. 39-40).

[7] Moreover, the net renegotiation repayments totalled $978,557.35 (Pet. 40) while the accumulation of earnings over the four-year period for which the accumulated earnings tax was imposed reached $2,528,642.29 (Pet. 37), so that significant accumulations would have remained even if the renegotiation liabilities had been considered.

score of factors demonstrating that the working capital needs did not justify the accumulation (Pet. 48-49).

2. Contrary to petitioner's argument (Pet. 18-20) the Tax Court was not required to credit the accumulated earnings and other tax liabilities at issue in this case against 1951-1954 income in its computation of the accumulated earnings tax.[8] Section 102(d) of the 1939 Code defines the income subject to the accumulated earnings tax to be net income minus, among other items (Pet. 4-5), "Federal income * * * and excess-profits taxes * * * paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, *but not including the tax imposed by this section* * * *".[9] (Emphasis supplied.) The italicized clause expressly requires that the accumulated earnings tax not be deducted. As for the other adjustments in petitioner's tax liabilities, the court of appeals properly held that taxes "paid or accrued during the taxable year" do not include the contested tax liability determined to be owing in this proceeding. The general rule announced in *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, is that a contested tax liability may be accrued only in the year in which the contest is resolved. See also *Security Mills Co.* v. *Commissioner*, 321 U.S. 281; *United States* v. *Consolidated Edison Co.*, 366 U.S. 380. The authorities

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[8] The second line of the chart at the top of p. 7 of the petition apparently assumes that petitioner is entitled to have the accumulated earnings taxes deducted from earnings in the determination of whether the accumulation was unreasonable.

[9] See, also, section 535(b)(1) of the 1954 Code.

that petitioner says (Pet. 18-19) are to the contrary either permit a cash basis taxpayer to deduct an unpaid but uncontested tax liability in the year in which it accrues [10] or deal only with retroactive adjustments to the earnings and profits account after the fixing of the contested taxes. The latter authorities expressly distinguish the issue of whether contested taxes are deductible in the year the liability is asserted. *Drybrough* v. *Commissioner*, 238 F.2d 735, 739 (C.A. 6); cf. *Demmon* v. *United States*, 321 F.2d 203, 205 (C.A. 7).

3. The court of appeals correctly held (Pet. 29-36) that the Commissioner may assert deficiencies against separate taxpayers based upon alternative theories to protect against a possible defeat in litigation on one theory while the alternative and ultimately correct theory becomes time barred. This practice has long since been accepted as necessary in appropriate circumstances to avoid the loss of revenues. See *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308; *Revell, Inc.* v. *Riddell*, 273 F.2d 649 (C.A. 9), certiorari denied, 364 U.S. 835; *Malat* v. *Commissioner*, 302 F.2d 700 (C.A. 9), certiorari denied, 371 U.S. 934. Petitioner's contention (Pet. 21-22) that alternative determinations do not satisfy the Commissioner's statutory duty to "determine the correct amount of the tax" (Section 57 of the 1939 Code) would require the Commissioner to gamble on which one of several available theories is most likely to be accepted by the

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[10] See *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (C.A. D.C.); *Birmingham* v. *Loetscher Co.*, 188 F. 2d 78 (C.A. 8).

courts, at the cost of losing the revenue involved altogether if his choice is ultimately rejected. (Pet. 21-22.) Such a rule would serve no public purpose and could operate only to absolve large numbers of taxpayers from paying taxes they properly owe.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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